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MICHAEL RODAK, JR.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1323

GENERAL MOTORS ACCEPTANCE CORPORATION AND DAVE WAITE PONTIAC, INC.,
Petitioners,

vs.

WILLARD D. EASON, M. O. SATROM, AND JEAN M. SATROM,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

PETITIONERS' REPLY BRIEF

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PETITIONERS' REPLY BRIEF

Respondents' brief in opposition to petitioners' request that a writ of certiorari to the United States Court of Appeals for the Seventh Circuit issue in this case presents essentially three arguments for denial of the petition for a writ of certiorari—namely, that there is in fact no conflict between the decision of the Seventh Circuit here and the decisions of other courts of appeals; that the issue decided by the Seventh Circuit has already been authoritatively resolved by this Court; and that other grounds exist for the decision of the Seventh Circuit which make the question presented by the petition inapplicable and which, in any event, will necessarily have to be considered by this Court upon full review of this case thereby making review

inappropriate. As will be seen, each of these arguments is devoid of merit. Consequently, the petition for a writ of certiorari of the Seventh Circuit in this case should be granted.

1. Respondents' Contention That the Decision in This Case Is Not in Conflict with the Decision of Other Courts of Appeals Approving the Birnbaum Doctrine.

Respondents argue that no conflict exists between the decision of the Court of Appeals for the Seventh Circuit expressly rejecting the purchaser-seller limitation, first announced in *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (2d Cir.), *cert. denied*, 343 U. S. 956 (1952), and the decisions of other courts of appeals which have expressly refused to reject that limitation. This argument is predicated upon the erroneous assumption that the liberalized interpretation of *Birnbaum*—to which respondents refer as "references of fealty to *Birnbaum*" and to which the Seventh Circuit has referred as continuing "to pay homage to *Birnbaum*"—is a mere subterfuge adopted by other courts of appeals to conceal the fact that in reality they also have rejected *Birnbaum* sub silentio. The recent decision of the Fifth Circuit in *Smallwood* v. *Pearl Brewing Co.*, 489 F. 2d 579 (5th Cir. Feb. 19, 1974) is directly responsive to this contention.

In discussing that decision, respondents state:

> "Some circuits, like the Second, Third, and Fifth, purport to accept the *Birnbaum* purchaser-seller limitation, but then extend 10b-5 protection by treating persons as purchasers or sellers even though they are not, as in the recent decision in *Smallwood* v. *Pearl Brewing Co.*, 489 F. 2d 579, 590, 592 (5th Cir. 1974)." (Br. in Opp., at 14).

Yet in *Smallwood*, Judge Wisdom, speaking for the court, in fact said:

> "A. *Rule 10b-5*—Rule 10b-5 has a specific and narrow task—to protect purchasers and sellers of securities from fraud perpetrated 'in connection with the purchase or

> sale of any security.' In Birnbaum v. Newport Steel Corp., 2 Cir. 1952, 193 F. 2d 461 cert. denied, 343 U. S. 956 . . ., the Second Circuit refused standing under the Rule to plaintiffs who were not alleged to be either purchasers or sellers of securities. This Court has consistently followed the *Birnbaum* rule. See Hooper v. Mountain States Securities Corp., 5 Cir. 1960, 282 F. 2d 195, 201, cert. denied, 365 U. S. 814 . . .; Rekant v. Desser, 5 Cir. 1970, 425 F. 2d 872, 877; Herpich v. Wallace, 5 Cir. 1970, 430 F. 2d 792, 806. We are persuaded, moreover, that, at least with respect to actions for damages, *Birnbaum* maintains its vitality in most circuits. See, e.g., Iroquois Industries, Inc. v. Syracuse China Corp., 2 Cir. 1969, 417 F. 2d 963, 968; Greenstein v. Paul, 2 Cir. 1968, 400 F. 2d 589, 581; City National Bank v. Vanderboom, 8 Cir. 1970, 422 F. 2d 221, 228, cert. denied, 399 U. S. 905. . . . *But see Eason* v. *General Motors*, 7 Cir. Dec. 28, 1973, 42 LW 2358 F. 2d .....
>
> ". . . To prevent the *Birnbaum* doctrine from limiting too severely the ability of Rule 10b-5 to meet the broad purposes of the Act, 'seller' has been stretched beyond its common law sense. See, e.g., Hooper v. Mountain States Securities Corp., *supra* (corporation issuing its own stock); Vine v. Beneficial Finance Co., 2 Cir. 1967, 374 F. 2d 627, cert. denied, 389 U. S. 970 . . . (short-form merger). For our present purposes, the most important extension of the Rule 10b-5 definition is the treatment of a merger as a purchase or sale." 489 F. 2d at 589-90 (emphasis added).

Thus, the Court of Appeals for the Fifth Circuit not only clearly recognizes a conflict between its own decisions and this case, but also states in effect that it is persuaded that *Birnbaum* retains its vitality in most circuits, notwithstanding the views of the Seventh Circuit. If other courts of appeals which have held that *Birnbaum* retains its vitality follow Judge Wisdom's view, it would appear that the increase in the workload anticipated by Judge Stevens as a result of the complete abandonment of *Birnbaum* will fall exclusively on the Seventh Circuit, at least until the conflict is resolved by this Court.

The principle underlying the liberalized interpretation of *Birnbaum* was stated by this Court in *SEC* v. *National Securities, Inc.*, 393 U. S. 453, 466-67 (1969) (emphasis added):

> ". . . The meaning of particular phrases must be determined in context, *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U. S. 344, 350-351 (1943). Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase 'unless the context otherwise requires.' 1933 Acts, § 2, 48 Stat. 74, 15 U. S. C. § 77b; 1934 Acts, § 3, 48 Stat. 882, 15 U. S. C. § 78c. We must therefore address ourselves to the meaning of the words 'purchase or sale' *in the context of § 10(b).* Whatever these or similar words may mean in the numerous other contexts in which they appear in the securities laws, only this one narrow questions is presented here. . . .
>
> ". . . Whatever the terms 'purchase' and 'sale' may mean in other contexts, here *an alleged deception* has affected individual shareholders' decisions in a way not at all unlike that involved in a typical cash sale or share exchange."

Against this background, it is clear that what the courts of appeals approving *Birnbaum* have been saying is not that persons who are neither sellers nor purchasers of securities may nevertheless have standing to maintain 10(b) actions, but that persons may be deemed to be purchasers or sellers of securities for purposes of § 10(b), although they are not purchasers or sellers in the common-law sense or in the usual and ordinary sense, in order "to prevent ingenious minds from deflecting the statutory purposes of Section 10(b)," 489 F. 2d at 590, and to ensure "that the broad design of the section and the rule is not frustrated by the use of novel or atypical transactions," 430 F. 2d at p. 807.[1]

1. Indeed, the contention that the *Birnbaum* doctrine has been so eroded by cases applying the liberalized interpretation of *Birnbaum* that it no longer has vitality is not new. It was expressly made and rejected in both *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F. 2d 763 (2d Cir. 1969), *cert. denied*, 399 U. S. 909

Respondents' statement to the effect that the Seventh Circuit in this case has merely extended the liberalized interpretation of *Birnbaum* with different phrasing is untenable. (Br. in Opp., at 14.) Under the Seventh Circuit's opinion here, the only purchase or sale of a security involved in connection with a possible § 10(b) violation was Bank Service's sale of its stock to Waite Leasing, and the Court of Appeals expressly rejected respondents' contention that they should be characterized as "sellers" of that stock (App. I, p. A3). Moreover, petitioners are unaware of and respondents do not cite a single prior decision in which individuals such as respondents, who bear only a tangential relationship to the sale of securities as shareholders of the selling party, have been accorded *personal* standing to sue under § 10(b) for alleged fraud in connection with such sale. Certainly it is, in all events, evident from Judge Wisdom's recent opinion in *Smallwood* v. *Pearl Brewing Co.*, 489 F. 2d at 589-90, that the Court of Appeals for the Fifth Circuit is in direct conflict with the Seventh Circuit. It is, in sum, difficult to imagine a case which more clearly than this one presents a conflict between the courts of appeals and which is therefore more in need of this Court's attention.

2. Respondents' Contention That This Court Has Heretofore Passed Upon the Correctness of the Birnbaum Doctrine.

Ignoring the Court's own remarks, respondents seize upon the Seventh Circuit's strained assertions that both aspects of the *Birnbaum* decision—that is, that § 10(b) not only was not intended to reach fraudulent mismanagement of corporate affairs but also could not be invoked by anyone other than a purchaser or seller of securities, 193 F. 2d at 464—were rejected in *Superintendent of Insurance of the State of New York* v. *Bankers Life & Casualty Co.*, 404 U. S. 6 (1971). To demonstrate the clear fallacy of this position, it is necessary only to

(1970), and *Mount Clemens Industries, Inc.* v. *Bell*, 464 F. 2d 339, 341 (9th Cir. 1972).

reiterate the precise parameters of the *Bankers Life* decision as stated by this Court:

> "Petitioner's complaint bases his single claim for recovery alternatively on three different transactions alleged to confer jurisdiction under § 10(b): Manhattan's sale of Treasury bonds; the sale of Manhattan stock by Bankers Life to Bourne and Begole; and the transactions involving the certificates of deposit. *We hold only that the alleged fraud is cognizable under § 10(b) and Rule 10b-5 in the bond sale and we express no opinion as to Manhattan's standing under §10(b) and Rule 10b-5 on other phases of the complaint.* See Kellogg, The Inability to Obtain Analytic Precision Where Standing to Sue Under Rule 10b-5 is Involved, 20 Buffalo L. Rev. 93 (1970); Lowenfels, The Demise of the *Birnbaum* Doctrine: A New Era For Rule 10b-5, 54 Va. L. Rev. 268 (1968)." 404 U. S. at 13-14 n. 10 (emphasis added).

Manhattan Casualty Co., on whose behalf *Bankers Life* was brought, was, in fact, the seller of the Treasury bonds involved in the allegedly fraudulent machinations of the defendants in that case, and thus the decision, limited as it was to the actionability of the alleged fraud "in the bond sale," simply did not require review of the second aspect of *Birnbaum*—the purchaser-seller limitation on standing to sue under § 10(b) and Rule 10b-5. As a consequence, this Court made clear that it did not reach that second aspect of *Birnbaum*, declining to express any "opinion as to Manhattan's standing under § 10(b) and Rule 10b-5 on other phases of the [*Bankers Life*] complaint" that challenged transactions in which Manhattan was not directly involved.

Moreover, despite assertions by both the Seventh Circuit and the respondents that the *Birnbaum* purchaser-seller limitation was a mere "appendage" of the now-rejected *Birnbaum* holding that § 10(b) was not intended to reach fraudulent mismangement of corporate affairs, 193 F. 2d at 464, nowhere is it explained why this is the case. Indeed, the essential fact is that the purchaser-seller limitation has a vitality completely in-

dependent from the other aspect of *Birnbaum*; the purchaser-seller limitation, as a condition to standing to sue under § 10(b) is as compatible with *Bankers Life's* expansive theory of the scope of fraudulent activity actionable under § 10(b) as it is with the *Birnbaum's* more restrictive theory. In either context, the real question for present purposes must be whether Congress intended to extend the protection of § 10(b) (and thereby of Rule 10b-5) to persons who have not purchased or sold securities in a transaction touched by alleged deceptive practices, 404 U. S. at 12-13.

In short, the correctness of the *Birnbaum* purchaser-seller limitation on standing to sue under § 10(b) and Rule 10b-5 is both a question important to judicial administration and application of the Federal securities laws and a question upon which this Court has not heretofore passed.

3. Respondents' Contention That the Decision of the Court of Appeals for the Seventh Circuit Is Correct for Reasons Other Than Those Challenged by the Petition.

Respondents also contended that the question presented by the petition is inapplicable and should not be reviewed by this Court because the decision of the Seventh Circuit is correct for other reasons which they say are not challenged by petitioners. They assert that under the facts alleged here they qualified as "purchasers" or "sellers" of "securities" on a number of bases, thereby satisfying the *Birnbaum* limitation. They argue that the guaranties delivered by them to GMAC are "securities" within the meaning of § 10(b); that in guaranteeing payment of indebtness to GMAC, they effectively contracted to purchase notes upon default of the principals, notes which constitute "securities" within the meaning of § 10(b); that they were "indirect sellers" of the 7,000 Bank Service shares transferred to Waite Pontiac by Bank Service under the sales agreement; and that they are entitled to maintain a derivative action on behalf of Bank Service.

None of these arguments was resolved by the Court of Appeals. Rather, considering "it appropriate to examine the viability of [the *Birnbaum*] rule first," that court assumed "that the only purchase or sale of a security involved . . . was the transfer of the 7,000 [Bank Service] shares . . ." and rejected "the suggestion that [respondents] should be characterized as 'sellers' of that stock." (App. I, p. A3). Since the Court of Appeals then proceeded to hold for respondents solely on the basis that they could maintain an action under § 10(b) notwithstanding they were neither purchasers or sellers of the 7,000 Bank Service shares, it was only that decision which petitioners could properly challenge before this Court in their petition for a writ of certiorari.

Under these circumstances, it is obviously absurb for respondents to suggest that the existence of other arguments not reached by the Seventh Circuit makes the question decided by that court inapplicable and not a proper subject for review by this Court. Respondents' additional arguments would once more have relevance here only if this Court should, upon full review, deem the present basis of the Seventh Circuit's decision—the invalidity of the *Birnbaum* purchaser-seller limitation—erroneous.

In this latter regard, it is also absurd for respondents to suggest that if this Court were to undertake review of the Seventh Circuit's decision, it would ultimately be compelled to resolve these additional arguments presented by them in support of the judgment below. (Br. in Opp., at 203). Plainly, such is not the case.

If review of this case were granted, respondents would, to be sure, be entitled under the established practice of this Court to assert in support of the judgment below any grounds appearing in the record, whether or not such grounds were relied upon or even considered in the lower courts. See, e.g., *Langnes* v. *Green*, 282 U. S. 531, 538-39 (1931); *United States* v. *American Ry.*

Express Co., 265 U. S. 425, 453-36 (1924). But it is, of course, well recognized that this Court can, in the exercise of its legitimate discretion, remand a case to the lower courts for initial consideration of such additional arguments. See e.g., *Aetna Cas. & Sur. Co.* v. *Flowers*, 330 U. S. 464, 468 (1947); *United States* v. *Ballard*, 322 U. S. 78, 88 (1944). Thus, contrary to the respondents' suggestion, "[r]eversal of the opinion [of the Seventh Circuit in this case certainly] would not require a negative response" to each of the additional arguments in support of the judgment below raised by respondents. (Br. in Opp., at 3).[2]

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2. While recognizing, then, the irrelevance of respondents' additional arguments for present purposes, it is nevertheless important to note that certain of those arguments are based upon a distortion of respondents' own pleaded allegations in this case. As to the guaranties and the notes, respondents assert before this Court that they "were induced to execute the agreement pursuant to which Bank Service purchased the business of Waite Leasing in exchange for 7,000 shares of Bank Service stock and, concurrently, to execute the Guaranty which was purchased by GMAC as a condition precedent to GMAC's investment in the Notes." (Br. in Opp., at 3.) Respondents also state that the "Guaranty was issued . . . as part of a single transaction involving the purchase of the business of Waite Leasing in *exchange for the* Notes, the Guaranty and 7,000 shares of the common stock of Bank Service" (Br. in Opp. at 15) (emphasis added); that GMAC was an investor in these notes; and that "GMAC would not have made that investment without the issuance of respondents' Guaranty," (Br. in Opp., at 16). Despite these assertions, it is clear from the record that the transaction at issue—the sale of Waite Leasing to Bank Service—involved neither any issuance or exchange of notes, nor the issuance of guaranties to GMAC.

As shown by petitioners' Statement of the Case which is supported by record references, the only notes involved in the sale were notes, secured by chattel mortgages, previously executed by Waite Pontiac with respect to indebtedness resulting from the purchase of automobiles for its leasing operations. GMAC owned those notes prior to the purchase by Bank Service and continued to own them thereafter. As part of the transaction *between* Waite Pontiac and Bank Service, then, Bank Service, as is alleged in the complaint and shown by the sales agreement, simply assumed Waite Pontiac's liability to GMAC on the existing notes—an act to which GMAC

CONCLUSION.

For the reasons stated in the petition and in this reply brief, it is respectfully submitted that the petition for certiorari should be granted.

Respectfully submitted,

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was not a party and thus clearly cannot be said to make GMAC a purchaser of a security.

To be sure, the sales agreement provided that Bank Service's shareholders would indemnify Waite Pontiac against liability to GMAC on the obligations assumed by Bank Service, and in compliance with this provision, the shareholders, including respondents, executed a guaranty to Waite Pontiac in an addendum to the agreement. But this guaranty to Waite Pontiac is not involved here. The guaranties to GMAC were issued not as a part of the purchase price, but rather, as is clearly alleged in the complaint, pursuant to an independent agreement with GMAC that it would consent to the transfer of the mortgaged assets to Bank Service and would also make future loans to Bank Service, or its subsidiary, provided guaranties of the assumed indebtedness and such future loans by GMAC were furnished. When a bank agrees to extend a line of credit to a borrower, it does not become a purchaser of, or an

investor in, notes evidencing the indebtedness, and by conditioning that line of credit of provision of a satisfactory guaranty, the bank does not become a purchaser of a security consisting of the guaranty or an investor in such guaranty. GMAC's position in the guaranty transaction was no different from that of a bank or other financial institution. And, the situation is not altered because the guaranty was furnished by a shareholder of a corporate borrower.

In attempting to characterize GMAC as an investor in "securities," respondents obviously hope to avoid the impact of *Lino* v. *City Investing Co.*, 487 F. 2d 689 (1973), in which the Third Circuit rejected the contention that a transaction in which notes and cash were given in payment for a franchise agreement constituted a sale or purchase of securities giving rise to an action under § 10(b) when coupled with allegations of fraud:

> ". . . [I]t is our view that the legislation was not intended to cover the transaction which occurred here. All of the definitional sections involved in this case are introduced by the phrase *'unless the context otherwise requires.'* The commercial context of this case requires a holding that the transaction did not involve a 'purchase' of securities. These were personal promissory notes issued by a private party. There was no public offering of the notes, and the issuer was the person claiming to be defrauded. The notes were not procured for speculation or investment, and there is no indication that [City Investing's subsidiary] was soliciting venture capital from Lino.
>
> ". . . .
>
> "In no way could City Investing be said to have 'purchased' Lino's notes for speculation or investment. City Investing was selling a certain contract right to Lino, not buying his security. It simply lacks common sense to describe the transaction as City Investing purchasing John Lino's security by paying him the right to operate one of its Franchise Sales Centers." 487 F. 2d at 694-95.

Under these principles, the notes involved here clearly were merely ordinary commercial notes issued or to be issued in ordinary loan transactions. And, while guaranties might be deemed "securities" within the meaning of § 10(b) in particular circumstances, cf. *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U. S. 344, 351 (1943), the commercial context of this case certainly compels, as it did in Lino, the further conclusion that the issuance and delivery of the guaranty to GMAC did not involve either a "purchase" or a "sale" of a "security".